Supreme Court, U.S.
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In The

Supreme Court of the United States

DAVID A. RAYMOND and
LORI RAYMOND,

v.

UNITED STATES OF AMERICA

**On Petition For A Writ Of Certiorari
To The United States Court Of Appeals
For The Second Circuit**

PETITION FOR A WRIT OF CERTIORARI

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QUESTION PRESENTED

Whether, under Section 61(a) of the Internal Revenue Code, 26 U.S.C. §61(a), a taxpayer's gross income from the proceeds of litigation includes the portion of his damages recovery that is paid to his attorneys pursuant to a contingent fee agreement.

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PETITION FOR A WRIT OF CERTIORARI

David A. Raymond and Lori Raymond petition for a writ of certiorari to review the judgment of the United States Court of Appeals for the Second Circuit in this case.

OPINIONS BELOW

The opinion of the Court of Appeals (*Infra*, App. 1-App. 21) is reported at 355 F.3d 107. The opinion of the United States District Court for the District of Vermont (*Infra*, App. 21-App. 36) is reported at 247 F. Supp.2d 548.

JURISDICTION

The judgment of the Court of Appeals was filed on January 13, 2004. The jurisdiction of this Court was invoked under 28 U.S.C. §1254. Three copies of this Petition have been served on the United States, by mailing them to the Solicitor General of the United States, Room 5614, Department of Justice, 950 Pennsylvania Avenue, N.W., Washington, DC 20530-0001.

STATUTORY PROVISIONS INVOLVED

Section 61(a) of the Internal Revenue Code, 26 U.S.C. §61(a) provides as follows:

> Gross income defined
>
> (a) General definition – Except as otherwise provided in this subtitle, gross income means all income

from whatever source derived, including (but not limited to) the following items:

(1) Compensation for services, including fees, commissions, fringe benefits, and similar items;

(2) Gross income derived from business;

(3) Gains derived from dealings in property;

(4) Interest;

(5) Rents;

(6) Royalties;

(7) Dividends;

(8) Alimony and separate maintenance payments;

(9) Annuities;

(10) Income from life insurance and endowment contracts;

(11) Pensions;

(12) Income from discharge of indebtedness;

(13) Distributive share of partnership gross income;

(14) Income in respect of a decedent; and

(15) Income from an interest in an estate or trust.

STATEMENT

This case presents the question whether or not that portion of a judgment paying an attorney's fees under a contingency fee agreement is income to the plaintiff for federal income tax purposes. Courts in the various circuits have reached conflicting results. The issue is the same as presented in two cases for which this Court has recently granted certiorari. *The Commissioner of Internal Revenue v. Banks*, No. 03-892; *The Commissioner of Internal Revenue v. Banaitis*, No. 03-907. This Court granted those petitions by orders dated March 29, 2004. For the reasons set forth below, the present Petition should be granted, or in the alternative, held pending the disposition of *Commissioner v. Banks* and *Commissioner v. Banaitis*.

1. Petitioner David Raymond was at one time employed by IBM Corporation. After being terminated in 1993, Mr. Raymond retained the law firm of Ouimette & Runcie to represent him in a wrongful termination suit against IBM. Under the fee agreement between Ouimette & Runcie and Petitioner, the attorneys would receive a contingent fee of 1/3 of the net recovery (in addition to expenses and a separate fee for any appeal). In May of 1995 Petitioner filed a complaint in the United States District Court for the District of Vermont.

The case against IBM went to trial and resulted in a verdict for Petitioner in the amount of $869,156. Judgment was entered on July 14, 1997, and later affirmed by United States Court of Appeals for the Second Circuit. *Raymond v. IBM Corp.*, 148 F.3d 63 (2d Cir. 1998)

IBM satisfied the judgment in 1998. The total amount paid by IBM was $929,585.90. Of the total proceeds,

$306,898.01 went to Mr. Raymond's attorneys under the contingent fee agreement.

2. When they originally filed their income tax return for 1998, Mr. and Mrs. Raymond included in their adjusted gross income all attorney's fees and expenses involved in securing this judgment. This included the contingent fee of $306,898.01. The inclusion of these fees in gross income had a drastic effect on the Raymonds' tax liability. Apart from the proceeds of the judgment, their income for the year was $63,369. With the full recovery of $929,585.90 treated as income, their adjusted gross income for 1998 became $1,002,955.

On the Raymonds' original tax return, the contingent fee was treated as a Miscellaneous Deduction on Schedule B. This was of no help to Mr. and Mrs. Raymond as their income tax was determined by the Alternative Minimum Tax. Miscellaneous Deductions are not deductible against the Alternative Minimum Tax. The result is that the Raymonds were required to pay taxes on the full amount of the judgment, including the $306,898.01 received by Mr. Raymond's attorneys.

3. The Raymonds later filed an amended return for 1998 (Form 1040X). On that amended return, they included in their gross income only the net proceeds of the judgment, excluding the contingent fee.

The Internal Revenue Service disallowed Mr. and Mrs. Raymond's claim for a refund. The Raymonds then filed an action in the United States District Court for the District of Vermont. Jurisdiction of that court was invoked under the provisions of 28 U.S.C. §1346(a)(1) and 26 U.S.C. §7422.

4. Both the government and the Raymonds moved for summary judgment. The district court granted the Raymonds' motion and denied that of the government. The court held that the portion of the judgment paying the contingent fee to Mr. Raymond's attorneys was not part of the Raymonds' gross income.

The court recognized the split in authority among the circuits. In arriving at its decision, the court considered both federal and state law. The court pointed out that those circuits that have included contingent fees as gross income to their clients have relied on the anticipatory assignment of income doctrine articulated in *Lucas v. Earl*, 281 U.S. 111 (1930) and *Helvering v. Horst*, 311 U.S. 112 (1994). *Infra*, App. 26-27. The court held that this doctrine does not apply in this situation. The decision was based in part on Vermont law. As the court noted, state law determines the nature of legal interest in property, although federal law does determine whether that interest will be taxed. *See Morgan v. Commissioner*, 309 U.S. 78, 80 (1940). In Vermont a client entering into a contingent fee with an attorney gives up a substantial amount of control for that portion of the claim. *Infra*, App. 33-34. Under that fee arrangement the attorney is paid from the recovery rather than by the owner of the claim. The attorney's fees do not satisfy a personal obligation of the client. *Infra*, App. 32-33. The court held that the contingent fee arrangement operates more like an assignment of income producing property than an assignment of future income from property. *Infra*, App. 36.

The court also noted that when the client transfers an interest in the claim through a contingent fee arrangement, the claim has not matured into the right to enjoy a gain; it has not yet been determined whether or not the

taxpayer has the right to any recovery at all. *Infra*, App. 34. Finally, the court also noted that contingent fee contracts are not employed as a skillfully devised tax avoidance scheme. In conclusion the court held as follows:

> Because the contingency fee agreement is not a tax avoidance scheme, it operates more like income-producing property than income from property, and in any event does not satisfy the substantial control test of the assignment of income doctrine...the portion of Raymond's recovery that was paid directly to his attorneys under their contingent fee agreement was not income to Raymond.

Infra, App. 36. The court granted summary judgment for the Raymonds and denied the motion filed by the government.

5. The Second Circuit Court of Appeals reversed and held that the portion of the income paid to Mr. Raymond's attorneys was to be included in his gross income for 1998. As does every court considering the issue, the court recognized the divergent views among the circuit courts. *Infra*, App. 5.

The court reviewed the anticipatory assignment of income doctrine as set forth in *Lucas v. Earl*, 281 U.S. at 114-15. The court held that the anticipatory assignment of income does apply in this situation, and rejected each of the conclusions of the district court. The court considered two issues to be of key importance to the application of the doctrine. The first is whether the taxpayer has assigned ownership and control of income producing property, rather than assigning the income. The second is that the realization of income may occur when the taxpayer

receives some benefit from the disposition of income. *Infra*, App. 11-12.

As to the first point, the court held that under Vermont law an attorney does not have a proprietary interest in his client's claim, but only a lien on the proceeds. *Infra*, App. 14-15. Because it is only a lien, the court found that the client retained substantial control and ownership of that part of the claim. *Id.* As to the second point, the court believed Mr. Raymond had received benefits from the agreement, in that it made it possible for him to secure legal representation to pursue his claim against IBM. *Infra*, App. 16.

The Court of Appeals rejected each of the other arguments of the district court. The court found that the contingent fee at least arguably satisfies a personal obligation of the client, as an attorney who was fired without cause would use his lien to retrieve his fee from the client. *Infra*, App. 18. The court found it unimportant that the taxpayer had not yet been found to have any right to a recovery, stating that this was also the case in *Lucas v. Earl*. *Infra*, App. 19. And the court noted that while a contingent fee agreement may not be a "skillfully devised" tax avoidance scheme, the exclusion of those fees from income would present that risk in the future. *Infra*, App. 20.

The court therefore concluded that the entire amount paid to Mr. Raymond's attorneys under the contingent fee arrangement should be included in his gross income.

REASON FOR GRANTING PETITION

This case presents the same question that is presented in *Commissioner v. Banks*, No. 03-892 and *Commissioner v. Banaitis*, No. 03-907. This Court has granted the Petitions filed in those cases and consolidated them for argument.

The question has been considered in most of the circuits, and those courts of appeal are in conflict on this point. In their reasoning, the circuits could not be more divided. Some circuit courts have held that this is exclusively an issue of federal law. *See, e.g.*, *Young v. Commissioner*, 240 F.3d 369, 378 (4th Cir. 2001); *Srivastava v. Commissioner*, 220 F.3d 353 (5th Cir. 2000). Others have held the resolution depends on how state law treats the contingent fee arrangement. *See, e.g.*, *Banaitis v. Commissioner*, 340 F.3d 1074, 1081 (9th Cir. 2003); *Cotnam v. Commissioner of Internal Revenue*, 263 F.2d 119 (5th Cir. 1959).

Among the courts holding that federal law controls, some have decided in favor of the government. *See, e.g.*, *Young v. Commissioner*, 240 F.3d at 377-78. On the other hand, courts in the Fifth and Sixth Circuits hold that while the issue is controlled by federal law, the contingent fee is not income to the taxpayer. *Banks v. Commissioner*, 345 F.3d 373 (6th Cir. 2003); *Srivastava v. Commissioner*, 220 F.3d 353 (5th Cir. 2000).

Of the courts holding that the result depends on state law treatment of a contingent fee, some have ruled in favor of the government, *Baylin v. Commissioner of Internal Revenue*, 43 F.3d 1451 (Fed. Cir. 1995), and some in favor of the taxpayer. *Estate of Clarks v. United States*,

202 F.3d 854 (6th Cir. 2000); *Cotnam v. Commissioner of Internal Revenue*.

In the Ninth Circuit, this has resulted in decisions in favor of the government in Alaska and California, *Coady v. Commissioner of Internal Revenue*, 213 F.3d 1187 (9th Cir. 2000); *Benci-Woodward v. Commissioner of Internal Revenue*, 219 F.3d 941 (9th Cir. 2000), and in favor of the taxpayer in Oregon. *Banaitis v. Commissioner*, 340 F.3d 1074 (9th Cir. 2003).

1. In reviewing this question, the starting point should be a consideration of the meaning of income. The classic statement about what constitutes income is found in *Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426 (1955). In two companion cases, corporations had received punitive damage awards. They argued that the awards did not constitute income under the Code and were therefore not taxable. This Court held that an award of punitive damages was income to the recipient, stating as follows: "Here we have instances of undeniable accessions to wealth, clearly realized, and over which the taxpayers have complete dominion." *Id.* at 431. That describes what is meant by income. Under that description, the contingent fee paid to an attorney rather than to the client should not be income to the client. There is for the client no "accession to wealth, clearly realized." His wealth will increase only by the net amount of the judgment, and not by the amount paid to the attorney as a contingent fee.

2. Those circuits that have decided this issue in favor of the government have generally relied to a large extent on the anticipatory assignment of income doctrine. This doctrine was articulated in cases such as *Lucas v. Earl*, 281 U.S. 111 (1930) and *Helvering v. Horst*, 311 U.S.

112 (1940). When one party assigns a fixed right to receive future income to a related party, courts may apply the assignment of income doctrine to charge the assignor, rather than the assignee, with the liability to pay taxes on the income. It is generally recognized that the purpose of the doctrine was to prevent taxpayers from defeating the graduated tax rate schedules by artificially dividing income among separate taxpayers who are actually part of the same economic unit. *See* Jensen, *SCHNEER V. COMMISSIONER*: CONTINUING CONFUSION OVER THE ASSIGNMENT OF INCOME DOCTRINE AND PERSONAL SERVICE INCOME, 1 Fla. Tax Rev. 623, 632 (1993). In *United States v. Basye*, 410 U.S. 441, 450 (1973), this Court stated that the doctrine "stands today as a cornerstone of our graduated income tax system."

When courts have relied on the assignment of income doctrine in cases considering contingent fees, they have usually done so with limited analysis of the doctrine. *See, e.g.*, *Young v. Commissioner*, 240 F.3d 369, 379 (4th Cir. 2001); *Kenseth v. Commissioner*, 259 F.3d 881, 884 (7th Cir. 2001); *Coady v. Commissioner of Internal Revenue*, 213 F.3d 1187, 1191 (9th Cir. 2000), *cert. denied*, 532 U.S. 972 (2001); *Benci-Woodward v. Commissioner of Internal Revenue*, 219 F.3d 941, 943-44 (9th Cir. 2000), *cert. denied*, 531 U.S. 1112 (2001); *Baylin v. Commissioner of Internal Revenue*, 43 F.3d 1451, 1454-55 (Fed. Cir. 1995).

The classic assignment of income case presents a situation quite different from the case at hand. This may be seen from a review of *Helvering v. Horst*, 311 U.S. 112 (1940). There the taxpayer owned bonds with coupons representing the right to receive interest. He gave coupons for certain years to his son, but kept the bonds himself. The son held the coupons but the father still owned the

actual bonds. This Court held that the income from the bonds should be attributed to the father for tax purposes.

The following factors were present in *Horst*: 1) the taxpayer's right to future income was clearly established; 2) there was no purpose for the transaction except to avoid taxes; 3) the assignee performed no services in exchange for the assignment; 4) the income from the bond was to be taxed to the assignor or the assignee, but not to both.

None of those factors are found in cases like the one at hand. A client who retains a lawyer under a contingent fee arrangement will rarely have a fixed right to receive any income when the fee agreement is executed. The value of a lawsuit is usually speculative and dependent on the services of his attorneys. At that time there is "no res, no fund, no proceeds, no vested interest, only a hope to receive money from the lawyer's efforts and the client's right, a right yet to be determined by judge or jury." *Estate of Clarks v. United States*, 202 F.3d at 857. The claim is "an intangible, contingent expectancy." *Id.*

In *Horst* there was no legitimate business purpose for the transaction. The only reason for the assignment was so that Mr. Horst could share his income with a family member and avoid higher tax rates. The assignment of income doctrine usually does not apply to an arm's-length transaction with a legitimate business purpose. *See Jones v. Commissioner*, 306 F.2d 292, 302 (5th Cir. 1962). When a client hires a lawyer in a contingent fee agreement there is a legitimate purpose. This is to enable the client to secure representation to pursue a claim against a third party, typically when the client could not afford an attorney otherwise. It is an arm's-length transaction.

In addition, Mr. Horst's son performed no services in exchange for the income he was given. There was no consideration; the transaction was entirely gratuitous. None of this is the case in the contingent fee context. There the lawyer provides very substantial services in exchange for a percentage of a hoped-for recovery. The award eventually shared by the attorney and the client is the product of the skill and effort supplied by the attorney.

Perhaps the most important point is that in *Helvering v. Horst*, *Lucas v. Earl*, and *Harrison v. Schaffner*, 312 U.S. 579 (1941) the question was whether assigned income would be "taxable as such to the assignor *or* to the assignees." 312 U.S. at 579 (emphasis added). In each case the Court was deciding whether the assignor or the assignee was to be charged with the income. It was to be one or the other, but not both. The assignment of interest doctrine is used to determine which party shall be charged with income to be taxed. In the present situation, the government says that both are to be taxed; the contingent fee is to be treated as income to the client (although he never received it), and income to the attorney as well.

3. Several Courts have also argued that a contingent fee paid to an attorney should be taxed to the client because it discharges an obligation the client has to the lawyer. *See, e.g.*, *Hukkanen-Campbell v. Commissioner*, 274 F.3d 1312, 1313-14 (10th Cir. 2001); *Young v. Commissioner*, 240 F.3d 369, 378 (4th Cir. 2001); *Sinyard v. Commissioner*, 268 F.3d 756, 758 (9th Cir. 2001). It has, of course, long been clear that a taxpayer who has a financial obligation satisfied by another has taxable income. *Old Colony Trust Co. v. Commissioner*, 279 U.S. 716, 729 (1929).

But this principle does not apply here. Under a contingent fee agreement the client assumes no personal responsibility for payment of the lawyer's fee, so no debt is discharged when that fee is paid. In *Estate of Button v. Alexander*, 112 Vt. 531, 28 A.2d 404 (1942), the Vermont Supreme Court quoted from *Barnes v. Alexander*, 232 U.S. 117 (1914):

> Barnes gave no general promise of reward; he did not even give a promise qualified and measured by success to pay anything out of his own property, referring to the fund simply as the means that would enable him to do it. He promised only that if, when, and as soon as he should receive an identified fund, one third of it should go to the appellees.

See, also, *Wilie v. Cox*, 56 U.S. 415, 420 (1853) ("The fund was looked to and not the personal responsibility of the owner of the claim"). That is the situation with a contingent fee. A contingent fee creates no personal obligation on the client's part. Since there is no personal obligation there is no debt. Since there is no debt there is no income to the taxpayer when the attorney's fee is paid from the recovery.

It is very different when a lawyer is hired on an hourly basis. Then the client owes a fee regardless of the result. The fee may be more than the recovery, or there may be no recovery at all. In any event, the client personally owes the lawyer a fee. If part of the client's recovery pays a fee incurred on an hourly basis, he is taxed because it represents the discharge of a personal obligation. Courts holding that a contingent fee should be taxed to the client generally fail to recognize this distinction. *See, e.g.*, *Young v. Commissioner*, 240 F.3d at 379.

4. The question is one of considerable importance. Contingent fees arise in a large number of cases. Many of these cases are civil rights cases. In the civil rights context, the income tax owed on an award may be more than the taxpayer-plaintiff's net recovery.

The present disparity in holdings by the different circuits presents potential problems for the administration of the Internal Revenue Code. Taxpayers in identical situations will be treated very differently depending on the circuit in which they happen to reside. In fact, given the present state of the law, a party prevailing in a lawsuit involving a large award might obtain more favorable tax treatments by moving to a state located in a different circuit before filing a tax return. It is plainly desirable to achieve uniform tax treatment in this very common situation.

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted,

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UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

August Term, 2003

(Argued: November 21, 2003 Decided: January 13, 2004)

Docket No. 03-6037

DAVID A. RAYMOND and LORI RAYMOND,

Plaintiffs-Appellees,

– v. –

UNITED STATES OF AMERICA,

Defendant-Appellant.

Before:

OAKES, POOLER, and WESLEY, *Circuit Judges*.

Appeal from the judgment of the United States District Court for the District of Vermont (William K. Sessions III, *Chief Judge*), entered on December 18, 2002, granting summary judgment to taxpayer-appellees on their claim that the portion of a judgment paid to their attorney as a contingency fee should be excluded from their gross income.

Reversed and remanded.

JAMES W. RUNCIE, ESQ., Ouimette & Runcie, Vergennes, VT, *for Plaintiffs-Appellees*.

KENNETH W. ROSENBERG, ESQ., Tax Division, Department of Justice (Eileen J. O'Connor, Assistant Attorney General, Richard Farber, Department of Justice, *on the brief*, Peter W. Hall, United States Attorney for Vermont, *of counsel*), Washington, D.C., *for Defendant-Appellant.*

WESLEY, *Circuit Judge*:

The Supreme Court has long asserted that "[i]n tax law, . . . substance rather than form determines tax consequences." *Cottage Sav. Ass'n v. Comm'r,* 499 U.S. 554, 570 (1991) (Blackmun, J., dissenting) (citing *Comm'r v. Court Holding Co.,* 324 U.S. 331, 334 (1945)). In this appeal, we are presented with an issue in which the line between substance and form has blurred. The question presented is whether a taxpayer who receives a recovery for lost wages, and who agreed to pay his attorney on a contingent-fee basis, must include the contingent fee in his gross income. We answer that question in the affirmative.

I. Facts & Procedural Posture

Appellee-taxpayer Raymond entered into a contingent fee agreement with the law firm of Ouimette & Runcie, under which the firm agreed to represent Raymond in his wrongful termination suit against IBM in return for one-third of any recovery secured thereunder. In a jury trial in the United States District Court for the District of Vermont, Raymond prevailed; the court entered judgment on the jury's award of approximately $900,000. IBM satisfied the judgment by sending a check to Ouimette & Runcie, payable to Raymond. The firm deposited approximately

$300,000 in its own account in satisfaction of the contingent fee agreement.

On his federal income tax return for 1998, Raymond initially included in his gross income the entire amount of the judgment. From his gross income he attempted to deduct the amount of the fees paid to Ouimette & Runcie. *See* 26 U.S.C. § 212(1). However, due to the amount of Raymond's gross income, his tax liability was controlled by the Alternative Minimum Tax ("AMT"). As legal fees are among the itemized deductions that may not offset the AMT, *see* 26 U.S.C. § 56(b)(1)(A)(i), Raymond's tax liability was based on the sum of the entire judgment proceeds and his household income of approximately $65,000. Accordingly, his tax liability for 1998 was approximately $275,000.[1]

In December 1999, Raymond filed an amended 1998 return. On the amended return, he *excluded* from his gross income the amount paid to Ouimette & Runcie under the contingent fee agreement. This exclusion eliminated Raymond's AMT liability. Given the resulting adjustments on the amended return, Raymond calculated his tax liability for 1998 as approximately $220,000. He thus claimed the IRS owed him a refund of approximately $55,000. The IRS denied the claim.

Raymond filed suit in the United States District Court for the District of Vermont, pursuant to 28 U.S.C.

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[1] From Raymond's judgment, IBM had withheld approximately $243,000 for federal income tax. On his 1998 return, Raymond reported total withholdings of approximately $257,000. He thus owed approximately $18,000.

§ 1346(a)(1), challenging the IRS's denial of his refund claim. *See Raymond v. United States,* 247 F. Supp. 2d 548 (D. Vt. 2002). He moved for summary judgment contending that, as a matter of law, the amount paid as a contingent fee to his attorney was not includable in his gross income. The government cross-moved for summary judgment, arguing that the entire amount of the judgment was includable as gross income. The government maintained that the amount paid to Raymond's attorney was only deductible as a miscellaneous itemized deduction, as Raymond had claimed in his original return.

The district court granted Raymond's motion for summary judgment, holding the contingent fee excludable from gross income. *Id.* at 556. The court held that, under Vermont law, a contingent fee agreement between taxpayer and attorney gives rise to an equitable lien in favor of the attorney on the taxpayer's recovery. *Id.* at 554 (citing *Estate of Button v. Anderson,* 28 A.2d 404, 406 (Vt. 1942)). This equitable lien, the court reasoned, effects a transfer to the attorney of a proprietary interest in the taxpayer's claim. *Id.* Thus, because the amount of the recovery used to pay the attorney's fee represents only the attorney's interest in the claim, it is gross income to the attorney, but not to the taxpayer. The court viewed Raymond as having an insufficient interest in that amount to permit a characterization of it as "income" to him. The government appealed.

II. Discussion

Whether contingent fees are includable in the gross income of a client recovering on a judgment is the subject of much debate among the circuit courts.[2] The majority position is that such fees are includable in the client's gross income. *See Campbell v. Comm'r,* 274 F.3d 1312 (10th Cir. 2001); *Kenseth v. Comm'r,* 259 F.3d 881 (7th Cir. 2001); *Young v. Comm'r,* 240 F.3d 369 (4th Cir. 2001); *Baylin v. United States,* 43 F.3d 1451 (Fed. Cir. 1995). The minority position is that contingency fees are income to the attorney, but not to the client. *See Davis v. Comm'r,* 210 F.3d 1346 (11th Cir. 2000); *Estate of Clarks v. United States,* 202 F.3d 854 (6th Cir. 2000); *Cotnam v. Comm'r,* 263 F.2d 119 (5th Cir. 1959).[3]

Courts to address the issue have generally recognized that, in applying a federal revenue act, state law determines the nature of legal interests in property, while federal law determines the tax consequences of the receipt or disposition of property. *See United States v. Nat'l Bank of Commerce,* 472 U.S. 713, 722 (1985); *Aquilino v. United States,* 363 U.S. 509, 513-14 (1960). Thus, the courts have

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[2] It is settled law that some recoveries, such as those for "personal physical injuries or physical sickness," are excluded from the definition of gross income. 26 U.S.C. § 104(a)(2); *see also Duse v. IBM Corp.*, 252 F.3d 151, 160 (2d Cir. 2001). Raymond's recovery of lost wages does not enjoy this exclusion.

[3] The Ninth Circuit has held both that contingency fees are includable in the client's gross income *and* that they are not – depending on the state law involved. *Compare Coady v. Comm'r,* 213 F.3d 1187 (9th Cir. 2000) (includable under Alaska law), *and Benci-Woodward v. Comm'r,* 219 F.3d 941 (9th Cir. 2000) (includable under California law), *with Banaitis v. Comm'r,* 340 F.3d 1074 (9th Cir. 2003) (not includable under Oregon law).

typically first analyzed state law to determine the relative strength of the respective interests in the contingency fee. Where the attorney's interest in the fee is sufficiently strong, some courts – those in the minority – have held that the attorney has a "property" interest in it exclusive of the client's interest; from this, these courts conclude that the fee was never income to the client, but only to the attorney. Other courts – those in the majority – have determined that although state law might provide attorneys with an interest in the fee, that interest is merely a "security" interest; from this, they conclude that the fee is plainly income to the client, albeit income upon which the attorney has a lien.[4]

Notwithstanding the prevalence of state-law analysis in this area, several courts have expressly disavowed reliance on such analysis. In *Young,* the Fourth Circuit stated that "whether amounts paid directly to attorneys under a contingent fee agreement should be included within the client's gross income should be resolved by proper application of federal income tax law, not the amount of control state law grants to an attorney over the client's cause of action." *Young,* 240 F.3d at 378. And in *Banks v. Commissioner,* 345 F.3d 373 (6th Cir. 2003), the court reversed the Tax Court's determination that the fee was includable in gross income, despite the fact that the contingent fee agreement was controlled by *California* law, thus diverging from *Benci-Woodward* on *federal* grounds.

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[4] Indeed, to the extent that most courts to consider the issue have indicated that the analysis of state law is determinative, this is perhaps not a true "circuit split."

See id. at 385-86; *see also Srivastava v. Comm'r,* 220 F.3d 353, 363-64 (5th Cir. 2000).

Before turning to the analysis of the present case, it should be noted that the minority position in this area is weaker than it may first appear, at least quantitatively. The Fifth Circuit was the first to speak on this issue, and it held that contingent fees are not includable in the gross income of the client. *See Cotnam,* 263 F.2d at 125. In *Cotnam,* the court held that, under Alabama law, a contingent fee arrangement effected an assignment of a portion of the client's claim to her attorney as of the date she entered into the contingent fee arrangement.[5] This assignment, reasoned the court, sufficiently deprived the client of control over that portion of the claim such that income derived therefrom was not the client's, but rather the attorney's.

Since *Cotnam,* only two circuit courts have defended the view originally articulated in that case. In *Srivastava,* the Fifth Circuit engaged in a lengthy analysis demonstrating why the *majority* position appears most sound – but then followed *Cotnam* as a matter of stare decisis. *See Srivastava,* 220 F.3d at 357-65. And in *Davis,* the Eleventh Circuit followed *Cotnam* insofar as it serves as "former Fifth Circuit" precedent – but offered no argument in its

[5] The court relied heavily on the fact that Alabama law provided attorneys with liens against fees earned, and that "attorneys at law shall have the same right and power over . . . suits, judgments and decrees, to enforce their liens, as their clients had or may have for the amount due thereon to them." *Cotnam,* 263 F.2d at 125 (quoting 46 Code of Alabama § 64 (1940)).

support. *See Davis,* 210 F.3d at 1347.[6] This leaves just the Sixth and the Ninth Circuits as having independently supported the position that contingent fees may be excluded from a client's gross income – the former on federal grounds and the latter on state grounds. *See Banks,* 345 F.3d at 386; *Banaitis,* 340 F.3d at 1083. With that as our backdrop, we enter the fray.

Section 61(a) of the Internal Revenue Code defines "gross income" as "all income from whatever source derived." 26 U.S.C. § 61(a). The Supreme Court has broadly construed this definition "in recognition of the intention of Congress to tax all gains except those specifically exempted." *Comm'r v. Glenshaw Glass Co.,* 348 U.S. 426, 430 (1955). Still, the Court has long held that income is not taxable unless and until it is "realized." *See Helvering v. Horst,* 311 U.S. 112, 115 (1940). That is, a gain is taxable not when the taxpayer acquires the right to receive it, but rather when the taxpayer receives the benefit of it. *See id.* And a taxpayer can receive the benefit of a gain not only by being *paid,* but also by otherwise "obtain[ing] the fruition of the economic gain which has already accrued to him." *Id.* For example, a taxpayer realizes income when a third party satisfies a financial obligation of the taxpayer; the taxpayer is treated as having received that amount as income and is taxed accordingly. *See Old Colony Trust Co. v. Comm'r,* 279 U.S. 716, 729 (1929). This is true regardless of whether the amount ever passed through the taxpayer's hands. *See Horst,* 311 U.S. at 116.

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[6] The *Davis* court explained that it was bound by *Cotnam* because only an en banc court could overrule that case. *See Davis,* 210 F.3d at 1347 n.4.

In addition to explaining that income is not taxable unless and until realized in some form, the Supreme Court has crafted the "anticipatory assignment of income" doctrine, under which taxpayers are prevented from avoiding the realization of income. *See Lucas v. Earl,* 281 U.S. 111, 114-15 (1930); *Horst,* 311 U.S. at 119-20. In *Earl,* a husband and wife contracted in 1901 that they would hold all of their future income as joint tenants. *Earl,* 281 U.S. at 113-14. On his tax returns for 1920 and 1921, the husband thus claimed only half the income earned in those years.[7] The Court held that the husband's taxable income was determined not by the anticipatory contract with his wife, but rather by the amount the husband actually earned in the tax years in question. Justice Holmes wrote:

> There is no doubt that the [Code] could tax salaries to those who earned them and provide that the tax could not be escaped by anticipatory arrangements and contracts however skilfully devised to prevent the salary when paid from vesting even for a second in the man who earned it. That seems to us the import of the statute before us and we think that no distinction can be taken according to the motives leading to the arrangement by which the fruits are attributed to a different tree from that on which they grew.

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[7] When *Earl* was decided, married couples could not yet file joint tax returns as one economic unit. *See* WILLIAM A. KLEIN ET AL., FEDERAL INCOME TAXATION 667-71 (12th ed. 2000) (discussing how Congress first permitted "income splitting" between married couples in 1948, how this initially created a "marriage bonus" – and corresponding "singles penalty" – and how a subsequent adjustment to the rate structure eliminated the singles penalty, but created the current "marriage penalty").

Earl, 281 U.S. at 114-15. The doctrine is a practical necessity in a system of graduated taxation; without it, a taxpayer in a high tax bracket could avoid heightened levels of taxation by simply shifting income to a lower-bracket taxpayer. Although this *may* not have been the intention of the husband and wife in *Earl,* the Court declined to give weight to "the motives leading to the arrangement," presumably because such a "motives" test would be judicially intractable and subject to abuse.[8]

The Court applied the doctrine again in *Horst.* In that case, the taxpayer made a gift of bond coupons to his son – but retained the bonds. His son redeemed the coupons in the same year. In completing his income tax return, the taxpayer failed to include the redemption proceeds in his gross income. *Horst,* 311 U.S. at 114. The Court held that the taxpayer was obligated to include the bond interest in his gross income. *Id.* at 120. Justice Stone wrote that "he,

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[8] In that same year, the Supreme Court also held that a married couple could "split" income derived from property co-owned by operation of law, in a community property state. *See Poe v. Seaborn,* 282 U.S. 101 (1930). The difference between *Seaborn* and *Earl,* and between *Seaborn* and the present case, is twofold. First, the *Seaborn* Court stressed that, there, "the earnings [were] *never* the property of the husband, but that of the community," whereas in *Earl,* the agreement was effectively premised on the notion that one-half of the husband's property would be assigned to his wife upon receipt. *Id.* at 117 (emphasis added). Second, the *Seaborn* Court appears to have given some weight to the fact that the property was co-owned "by law." *Id.; see also Armantrout v. Comm'r,* 67 T.C. 996, 1007 (1977), *aff'd per curiam,* 570 F.2d 210 (7th Cir. 1978) (noting the "consensual nature of the method of compensation" in determining that the portion of a taxpayer's compensation placed directly into a college fund constituted gross income). We believe that Raymond's *private* agreement to assign a portion of *his* income to his attorney is more akin to *Earl* than it is to *Seaborn.*

who owns or controls the source of the income, also controls the disposition of that which he could have received himself and diverts the payment from himself to others as the means of procuring the satisfaction of his wants." *Id.* at 116-17. Further, the Court declared that "[t]he power to dispose of income is the equivalent of ownership of it." *Id.* at 118. Because the taxpayer had retained control of the bonds, he retained control of the disposition of the income. That is, he retained the power to divert the income to his son. He "gained" by receiving the satisfaction of giving the income to his son. That gain constituted gross income.

At least two notions seem to be at the heart of the holding in *Horst*. First, as the district court noted, *see Raymond,* 247 F. Supp. 2d at 552, the Court distinguished between assigning income-producing property and assigning income derived from property still controlled by the taxpayer. When a taxpayer effects the former, he is not properly treated as the recipient of income derived therefrom; in such a case, the taxpayer has relinquished control over the disposition of the income. But when a taxpayer effects the latter, he is treated as the recipient of income despite having "shifted" it to another. Distinguishing between the two turns on the extent to which the taxpayer has retained control of the "source of the income." *Horst,* 311 U.S. at 116.

Second, *Horst* emphasizes that the "realization" of income – the "gain" derived from it – can take many forms. The key is that through controlling the disposition of income, the taxpayer has received some benefit. The Court explained of the taxpayer's gift of interest coupons:

> Such a use of his economic gain, the right to receive income, to procure a satisfaction which can be obtained only by the expenditure of money or property,

> would seem to be the enjoyment of the income whether the satisfaction is the purchase of goods at the corner grocery, the payment of his debt there, or such non-material satisfactions as may result from the payment of a campaign or community chest contribution, or a gift to his favorite son. Even though he never receives the money he derives money's worth from the disposition of the coupons which he has used as money or money's worth in the procuring of a satisfaction which is procurable only by the expenditure of money or money's worth. The enjoyment of the economic benefit accruing to him by virtue of his acquisition of the coupons is realized as completely as it would have been if he had collected the interest in dollars and expended them for any of the purposes named.

Horst, 311 U.S. at 117. Thus, the two notions are interrelated. Where a taxpayer assigns income-producing property to another, thereby relinquishing control over it, that taxpayer gives up the power to use that property in such a way as to realize a gain, tangible or intangible. But where a taxpayer retains control over an income-producing asset, thereby retaining control of the disposition of the income, that taxpayer has the power to gain through the satisfaction of assigning its income to whomever he pleases. Such a gain is gross income.

In the present case, the district court first examined Vermont law to determine the respective legal interests in the contingency fee in question. In *Button,* the Vermont court held that an attorney has an "equitable lien" on the amount of his contingency fee. *Button,* 28 A.2d at 406. Further, the district court noted that the Supreme Court has indicated that when an attorney has a lien for his fees, he has "an interest or share in the claim itself." *Raymond,*

247 F. Supp. 2d at 554 (quoting *Nutt v. Knut,* 200 U.S. 13, 20 (1906)). From these propositions, the district court concluded that, in Vermont, a "contingent fee agreement operates more like an assignment of income-producing property than an assignment of future income from property." *Raymond,* 247 F. Supp. 2d at 554. That is, when a client agrees to a contingent fee arrangement, he assigns to his attorney not merely the future income to be generated from the claim, but rather a portion of the claim from which future income will flow. He has "transferred some of the trees in his orchard, not merely the fruit from the trees." *Id.* at 555 n.6 (quoting *Estate of Clarks,* 202 F.3d at 858). Thus, the court concluded contingent fee arrangements do not violate the anticipatory assignment of income doctrine first articulated in *Earl.*

In *Button,* the State of Vermont hired a law firm to prosecute a claim against the United States. The firm was to be paid on a contingent fee basis. Vermont won its case, but the state treasurer refused to pay the fee on the ground that the state constitution required any payment from the treasury be made by special appropriation from the legislature. The Vermont Supreme Court held that the agreement between the state and the firm created "an equitable lien on the fund in favor of the attorney to the extent of the amount stipulated." *Button,* 28 A.2d at 406. In discussing whether satisfying that lien contravened the state constitution, the court stated:

> Although the legal title to the whole fund no doubt is in the State, the petitioners have equitable rights to that portion of the same which represents their fee. This part in all equity and good conscience belongs to them. They have earned it and should receive it. This portion of the fund *never legally and equitably be-*

> *longed* to the State as part of its public funds for, at the latest, when received, the lien attached to it and remains upon it so that it is held by the State subject to the same.

Id. at 410 (emphasis added). The court thus directed the state treasurer to pay the firm its fee.

Raymond argues that the strong language used in *Button* indicates that, under Vermont law, the interest that an attorney has in the contingent-fee portion of a judgment is a *property* interest. The client never owns it. Therefore, just as the taxpayer in *Cotnam* had an insufficient interest in the fee to make it taxable to her, the taxpayer in the present case never owned the contingent-fee portion of his judgment. It was not his income. However, Raymond's argument seems to rely on a narrow conception of ownership. To be sure the clients in *Button* and in the present case never had a right to retain that portion of their judgments represented by their attorneys' fees. But the concept of property is not exhausted by the right to possess; it is also about the right to control. It is clear that, for tax purposes, exercising the right to "control[] the disposition" of a fund is sufficient for the realization of taxable income. *Horst,* 311 U.S. at 116-117.

Further, a close reading of *Button* itself indicates that the lien in question was something less than a proprietary interest. Rather, the lien was a security interest in a fund owned by the client. In *Button,* the court distinguished between an "equitable lien" on a contingent fee and an attorney's "charging lien" on such a fee. *See Button,* 28 A.2d at 407. Although the difference between the two is not entirely clear from the opinion, it appears that the former provides a stronger interest in the fee. But in any case, the *Button* court made it clear that an "equitable

lien" does not "arise merely by virtue of a contract for a contingent fee. The test is whether the party contracting for the services sufficiently indicates an intention to make the fund described in the contract security for the debt." *Id.* Two things follow from this. First, it is questionable whether Raymond's attorney had an interest in the fee any stronger than an ordinary charging lien. And second, even if he had a stronger "equitable lien," such a lien is, in the words of *Button,* a matter of having "security for the debt." It is a security interest. One does not – indeed need not – have a security interest in one's own property.[9]

Finally, Vermont, like many states, retains a rule against champerty. *See* Vt. Rule Prof. Cond. 1.8(j). Vermont does provide for the common exception that an attorney and client may agree to a contingent fee arrangement, and *Button* provides that the attorney has a lien on that portion of the recovery representing his fee. But "neither a lien nor a contractual right is 'proprietary.'" *Kenseth,* 259 F.3d at 884. The *Kenseth* court similarly recognized that, "under Wisconsin law (as under that of every other state, as far as we know), . . . the [attorney]

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[9] Other language in *Button* supports reading it as providing for a security interest rather than a proprietary interest. For example, in the text immediately following the passage relied upon by Raymond, the *Button* court stated:

> It is not necessary to determine the exact nature of these equitable rights which the petitioners have in the fund for all of the cases having to do with such liens recognize that the owner of the same can enforce such rights against the *owner of the fund* in the way of securing payment from the fund in satisfaction of the lien.

Button, 28 A.2d at 410 (emphasis added). This passage can only be read to imply that the attorney seeking to press his interest against a contingent fee is *not* the "owner of the fund."

had a lien on the proceeds of any settlement or judgment to the extent of the contingent fee." *Id.* at 882. Nevertheless, the Seventh Circuit declined to conclude that the lien precluded the fee from being gross income of the client. For all of these reasons, we decline to conclude that Vermont law provides attorneys with a proprietary interest in their clients' claims.

In any event, we should remember that we are interpreting federal tax law. The analysis of whether something is "gross income" begins with whether it can reasonably be considered a "gain" to the taxpayer under 26 U.S.C. § 61(a). *See Glenshaw Glass,* 348 U.S. at 429-30. Raymond argues that he never received these funds. Indeed, he had no right to them, given the lien placed on them under Vermont law. However, as *Horst* makes clear, a taxpayer can realize a gain subject to taxation where, although he "never receives the money he derives money's worth from the disposition of [the source of the income] which he has used as money or money's worth in the procuring of a satisfaction which is procurable only by the expenditure of money or money's worth." *Horst,* 311 U.S. at 117. Raymond "control[led] the source of the income [and] . . . divert[ed] the payment from himself to others as the means of procuring the satisfaction of his wants." *Id.* at 116-17. He diverted a portion of his judgment to his attorney in the service of receiving the remainder of that judgment – certainly a result "procurable only by the expenditure of money or money's worth." *Id.* at 117. Accordingly, the judgment flowing to Raymond is income to him, and the expense of producing that income – his attorney's fee – is a deductible expense. *See* § 212(1). That the Alternative Minimum Tax precludes Raymond from taking advantage of that deduction is unfortunate, *see Kenseth,* 259 F.3d at

884-85, but it is not a reason to create an artificial contingent-fee exception to the rule that one is taxable on income from a source over which one retains control.

The district court suggested that Raymond did not control the portion of his judgment earmarked for his attorney. *See Raymond,* 247 F. Supp. 2d at 553. This is true in a narrow, proximate sense; once he agreed to a contingent fee arrangement, Raymond gave up his right to a portion of his judgment once a judgment was obtained. However, the same was true in *Horst.* There, the taxpayer gave up his right to the interest derived from his bond coupons. But there, as here, the taxpayer controlled the source of the income. In *Horst,* it was the taxpayer's bond. Here, it was Raymond's claim against IBM. He could have fired his attorney. He could have dropped the case. He, and only he, had the power to authorize a settlement of the claim.[10] In this case and in *Horst* the taxpayers diverted income from their "property." In each, the taxpayers gained by doing so. Indeed, as in *Horst,* Raymond's income was "realized as completely as it would have been if he had collected the [judgment] in dollars" and then paid his attorney. *Horst,* 311 U.S. at 117. Thus, in the face of *Earl* and *Horst,* Raymond asks this Court to permit him to engage in an anticipatory assignment of income.

The district court offered three further observations in support of its conclusion that contingent fee arrangements fall outside the doctrine of anticipatory assignment of

[10] Indeed, if Raymond's attorney had this power, a conflict of interest would necessarily result. Hence the need for a rule against champerty.

income. First, the court stated that under such an arrangement the client "incurs no personal obligation for the services provided." *Raymond,* 247 F. Supp. 2d at 555. This suggestion is apparently meant to remove this case from the rule that a when a third party – here IBM – satisfies a taxpayer's personal obligation to another, that taxpayer is treated as the recipient of gross income. *See Old Colony,* 279 U.S. at 729. Under a contingent fee agreement, if there is no recovery, the client owes the attorney nothing (save expenses). Thus, the district court concluded, the payment of the contingent fee to the attorney is not the satisfaction of the client's obligation – and therefore is not a "gain" to the client. However, it is not clear that the district court is correct that there is no personal obligation running from client to attorney that is satisfied by the payment of the contingent fee. If the client were to fire the attorney (without cause) prior to securing a judgment, and thus had the entire judgment in hand, the attorney would utilize his lien to retrieve – from the client – his portion of that judgment. When this payment is made directly to the attorney in the normal case, it arguably satisfies an obligation for which the client contracted when agreeing to the fee arrangement. It seems no less the satisfaction of an obligation here.

Second, the court noted that at the time the client transfers the right to payment to the attorney, the "existence of the taxpayer's right to receive any recovery has yet to be determined." *Raymond,* 247 F. Supp. 2d at 555. The court suggested that this tells against treating the agreement as an assignment of income because, at the moment assigned, it is merely the assignment of a potentiality. At that time, the client has *no* right to any income, and thus cannot be thought to "shift" that income. Similarly,

Raymond argues that the anticipatory assignment doctrine should not apply to contingent fee situations because in contrast to the taxpayer in *Horst,* he had no right to any future income when he contracted with his attorney. As the Sixth Circuit explained, at the time of the execution of the fee agreement, there "was no res, no fund, no proceeds, no vested interest, only a hope to receive money from the lawyer's efforts and the client's right, a right yet to be determined by judge and jury." *Estate of Clarks,* 202 F.3d at 857. But the same could be said of *Earl.* There, the husband and wife agreed to co-own any future income each might earn. There existed no sum certain at the time of the agreement, and yet once the husband earned income and claimed that a portion of it had shifted to his wife, the Court found it to be an improper assignment of income. In both this case and *Earl,* the taxpayers assigned the right to receive a portion of as yet unascertained income to another. And in both cases, the assignment was "ineffective to shift . . . tax liability." *Kenseth,* 259 F.3d at 884.[11]

Third, the district court stressed that contingent fee arrangements are "not employed as a 'skillfully devised' tax avoidance scheme, but to provide greater access to legal services, often in doubtful or risky cases, where the clients cannot afford to pay attorneys to pursue their claims." *Raymond,* 247 F. Supp. 2d at 555 (internal citation omitted). Once again *Earl* is instructive. There,

[11] It is clear that Raymond's chose in action vested him with a proprietary interest. He could potentially have borrowed against it or even assigned it to another – provided the other was not an attorney. It is this limitation on the power to assign that leads us to conclude that Raymond assigned not a proprietary, but rather a security, interest in his claim.

Justice Holmes declined to give weight to the "motives leading to the arrangement by which the fruits are attributed to a different tree from that on which they grew." *Earl,* 281 U.S. at 115. In *Earl,* the husband and wife may, in fact, have agreed to share assets not out of a desire to avoid taxes, but rather out of a sense of marital equity.[12] But Holmes implicitly recognized that to rest the applicability of a rule of law on ascertaining the "motives" of the parties is to court procedural unmanageability. If courts were to attempt to permit the anticipatory assignment of income only when employed for the best of intentions, they would find themselves in the position of having to divine the unknowable – and would open the door to abuse. Although contingent fee arrangements are undoubtedly one way to permit plaintiffs to bring suit when they otherwise might be financially unable, the exclusion of contingent fees from a client's gross income has the potential to "create an artificial, a purely tax-motivated, incentive to substitute contingent for hourly legal fees." *Kenseth,* 259 F.3d at 884.

Further, Raymond suggests that this case is relevantly different than *Horst* insofar as, here, the question is whether to treat only the attorney, or the attorney *and* the client, as having received income. In *Horst,* the transaction was a gift from father to son, and the question was whether to treat the father *or* the son as the recipient of income. But it makes little sense to distinguish between circumstances in which an attorney is paid on an hourly basis and those in which the client and attorney have

[12] That Mr. Earl was an attorney may shed some light on this question. *See Earl,* 281 U.S. at 113.

agreed to a contingent fee arrangement. *Cf. Kenseth,* 259 F.3d at 884. When a client pays an attorney on an hourly basis, the same fund generates gross income for each; the fund simply passes through the client's hands first. There seems no reason to treat contingent fee arrangements differently.

III. Conclusion

In sum, although the relative interests that attorney and client have in the contingent fee portion of a judgment are relevant to the taxation of that fund, state-law concepts of those interests must be read in the context of federal tax policies. We do not read Vermont law as providing attorneys with a proprietary interest in their clients' claims. Further, determining to whom income flows depends in large part upon who controls the source of the income. When a taxpayer is in sufficient control of the source of income, federal principles of taxation deem him the recipient of gross income upon its disposition. This is such a case. And at least in this case, we believe the result supports the primacy of substance over form. Raymond secured a judgment. He paid his attorney. The form that payment took is immaterial. Therefore, we reverse the district court's ruling and remand with instructions to grant summary judgment to the government and dismiss the complaint.

UNITED STATES DISTRICT COURT
FOR THE
DISTRICT OF VERMONT

DAVID A. RAYMOND and LORI RAYMOND,	:	
Plaintiffs,	:	
v.	:	Docket No. 2:01-cv-142
UNITED STATES OF AMERICA,	:	
Defendant.	:	

OPINION AND ORDER

(Filed Dec. 17, 2002)

In this action to recover an alleged overpayment of taxes, Plaintiffs David A. Raymond and Lori Raymond ("the Raymonds") and Defendant United States of America ("the IRS") have filed cross-motions for summary judgment, asserting that there are no material facts at issue in this proceeding, and that each is entitled to judgment as a matter of law. For the reasons that follow, the Raymonds' motion (Doc. 9) is granted, and the IRS's motion (Doc. 14) is denied.

The material facts are not in dispute.[1] After being terminated from employment at IBM in 1993, Plaintiff

[1] To obtain summary judgment, a party must "show that there is no genuine issue as to any material fact and that the moving party is entitled to a judgment as a matter of law." Fed. R. Civ. P. 56(c). When cross-motions for summary judgment are filed, a court "must evaluate each party's motion on its own merits, taking care in each instance to

(Continued on following page)

David Raymond retained the law firm of Ouimette & Runcie to represent him in a wrongful termination suit. The firm filed a complaint against IBM in 1995 in the United States District Court for the District of Vermont, Civil Action Docket Number 2:95-cv-158.

Under the fee agreement between Raymond and his attorneys, the firm would receive a contingency fee of 1/3 of the net recovery, plus expenses. Any fees incurred as a result of an appeal were to be paid at an hourly rate.[2]

Trial by jury resulted in a verdict in favor of Raymond in the amount of $869,156.00. Judgment was entered on the verdict on July 14, 1997. The judgment was affirmed on appeal by the United States Court of Appeals for the Second Circuit. After appeal, IBM satisfied the judgment in a total amount of $929,585.90, including $60,429.90 in interest. IBM broke down the total amount as follows:

Interest	$ 60,429.90
Check to Raymond	$548,107.84
Federal Income Tax Withholding	$243,363.68
Social Security Tax	$ 16,843.56
State Income Tax Withholding	$ 60,840.92
Total	$929,585.90

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draw all reasonable inferences against the party whose motion is under consideration." *Heublein, Inc. v. United States*, 996 F.2d 1455, 1461 (2d Cir. 1993).

[2] The specific wording of the contingent fee arrangement in Raymond's retainer agreement was: "Mr. Raymond agrees to pay Ouimette & Runcie as legal fees a sum equal to one-third of the net amount recovered by Mr. Raymond by settlement or judgment, after the deduction of reasonable expenses incurred in the prosecution of this matter." Retainer Agreement at ¶ 2 (Doc. 11, App. A).

IBM sent checks for the interest and principal to Ouimette & Runcie. After receipt by the law firm, Raymond's share of the proceeds was deposited into his account at the Chittenden Bank and Ouimette & Runcie's share was deposited into its account at the Chittenden Bank. Of the total amount recovered, Ouimette & Runcie received $306,898.01 under the contingency fee agreement, and an additional $32,732.11 in attorneys' fees and expenses for the appeal.

On the Raymonds' original 1998 federal income tax return, they included in their adjusted gross income the entire amount of the judgment, including the amounts paid as attorneys' fees. Because of the amount of their income for that year, the Raymonds' income tax was determined by the Alternative Minimum Tax ("AMT"). Ordinarily they would have been able to take a miscellaneous deduction for their attorneys' fees to the extent those fees exceeded 2% of their adjusted gross income, but miscellaneous deductions are not allowed under the AMT. The effect of the inclusion of the entire amount of the judgment as income and the operation of the AMT was to require the Raymonds to pay income tax on the full $929,585.90, although $306,898.01 of that amount went directly to their attorneys.

On December 28, 1999, the Raymonds filed an amended federal tax return and requested a refund of $55,489.00. On the amended return, the Raymonds excluded from their income amounts paid to Ouimette & Runcie under the contingency fee agreement. On April 14, 2000, the Raymonds' request for refund was denied by the IRS. They filed the instant suit for recovery of internal revenue taxes pursuant to 28 U.S.C. § 1346(a)(1) in the

United States District Court for the District of Vermont on May 4, 2001.

DISCUSSION

Under the Internal Revenue Code, "gross income means all income from whatever source derived." 26 U.S.C.A. § 61(a) (2002); *see also* 26 C.F.R. § 1.61-1 (2002) (gross income includes income realized in any form). In the landmark case of *Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426 (1955), the United States Supreme Court emphasized the "sweeping scope" of the definition of gross income, "in recognition of the intention of Congress to tax all gains except those specifically exempted." *Id.*, 348 U.S. at 429-30. Although the Internal Revenue Code's definition of gross income is to be broadly construed, exclusions from income are to be narrowly construed, however. *Taggi v. United States,* 35 F.3d 93, 95 (2d Cir. 1994).

Not all economic gain to a taxpayer is taxable income. Generally the "realization" of income – when the income is paid – is the taxable event, rather than the acquisition of the right to receive it. *Helvering v. Horst,* 311 U.S. 112, 115 (1940). Realization occurs when the taxpayer "obtains the fruition of the economic gain which has already accrued." *Id.* This rule has not been interpreted as permitting a taxpayer to escape taxation because the taxpayer has not personally received payment, however. *See id.*, 311 U.S. at 116. Thus if a taxpayer arranges for a creditor to be paid directly from income due the taxpayer, "he does not escape taxation because he did not actually receive the money." *Id.*

At issue is whether fees paid directly to an attorney under a contingency fee agreement should be excluded

from the client's gross income because it was income to the attorney and not to the client. There is a split of authority on the subject; the Fifth, Sixth and Eleventh Circuits exclude contingency fees from clients' gross incomes; the Third, Fourth, Seventh, Ninth, Tenth and Federal Circuits include them. *See Campbell v. Comm'r,* 274 F.3d 1312, 1314 (10th Cir. 2001), *cert. denied,* 122 S. Ct. 1915 (2002); *Kenseth v. Comm'r,* 259 F.3d 881, 885 (7th Cir. 2001); *Young v. Comm'r,* 240 F.3d 369, 379 (4th Cir. 2001); *Coady v. Comm'r,* 213 F.3d 1187, 1191 (9th Cir. 2000), *cert. denied,* 532 U.S. 972 (2001); *Davis v. Comm'r,* 210 F.3d 1346, 1347 (11th Cir. 2000) (per curiam); *Estate of Clarks v. United States,* 202 F.3d 854, 858 (6th Cir. 2000); *Baylin v. United States,* 43 F.3d 1451, 1454 (Fed Cir. 1995); *O'Brien v. Comm'r,* 319 F.2d 532, 532 (3rd Cir. 1963) (per curiam); *Cotnam v. Comm'r,* 263 F.2d 119, 126 (5th Cir. 1959). The Second Circuit has not had occasion to decide the issue.

Those courts that have included contingency fees paid directly to attorneys as gross income to their clients have relied on the anticipatory assignment of income doctrine first articulated in *Lucas v. Earl,* 281 U.S. 111 (1930). The anticipatory assignment of income doctrine was devised to prevent a taxpayer from assigning income before it is realized in order to avoid the tax consequences of earning it. Traditionally, the doctrine was applied to the donative transfer of income or property between family members. *See id.,* 281 U.S. at 113-14; *Horst,* 311 U.S. at 114; *see also Comm'r v. Sunnen,* 333 U.S. 591, 602-03 (1948).

In *Lucas v. Earl,* a husband and wife agreed to grant to each spouse one-half of their respective incomes. On the husband's tax return, he claimed only one-half of the income he earned. Justice Holmes, writing for a unanimous Court, concluded that the husband could not avoid

paying tax on income he earned by making an anticipatory assignment of that income to another:

> There is no doubt that the [Revenue Act of 1918] could tax salaries to those who earned them and provide that the tax could not be escaped by anticipatory arrangements and contracts however skilfully devised to prevent the salary when paid from vesting even for a second in the man who earned it. That seems to us the import of the statute before us and we think that no distinction can be taken according to the motives leading to the arrangement by which the fruits are attributed to a different tree from that on which they grew.

Id., 281 U.S. at 114-15. The essence of the doctrine thus was that income should be taxed to the one who earns it. *See also United States v. Basye*, 410 U.S. 441, 447 (1973).

In *Helvering v. Horst*, a taxpayer owner of negotiable bonds made a gift to his son of the interest coupons prior to the bonds' maturity. The taxpayer, who continued to keep the bonds, was required to include the interest in his gross income: "[h]e, who owns or controls the source of the income, also controls the disposition of that which he could have received himself." *Id.*, 311 U.S. at 116-17. Had the taxpayer transferred the bonds themselves, he would have given up the right to control the disposition of the income and would not have been taxed. In sum, the Court concluded, "[t]he power to dispose of income is the equivalent of ownership of it." *Id.*, 311 U.S. at 118.

The Court continued to employ the *Lucas v. Earl* orchard metaphor in *Horst*, stating that "[t]he import of the [1934 Revenue Act (taxing interest as well as income derived from wages)] is that the fruit is not to be attributed to a

different tree from that on which it grew." *Id.*, 311 U.S. at 120. It distinguished the situation in which a gift of income-producing property is made, as opposed to a gift of income derived from property, using another agricultural metaphor: "[u]nlike income thus derived from an obligation to pay interest or compensation, the income [from trust property] was regarded as no more the income of the donor than would be the rent from a lease or a crop raised on a farm after the leasehold or the farm had been given away." *Id.*, 311 U.S. at 119 (citing *Blair v. Comm'r*, 300 U.S. 5, 12, 13 (1937)[3]).

The critical factor in determining whether a taxpayer has engaged in an anticipatory assignment of income is the degree of control over the asset that the taxpayer has retained. *See Sunnen*, 333 U.S. at 604 ("crucial question remains whether the assignor retains sufficient power and control over the assigned property or over receipt of the income to make it reasonable to treat him as the recipient of the income for tax purposes"); *Srivastava v. Comm'r*, 220 F.3d 353, 363-64 (5th Cir. 2000); *see also White v. Fitzpatrick*, 193 F.2d 398, 402 (2d Cir. 1951) (tax consequences of intra-family transfer determined by ascertaining who has retained practical ownership of asset).

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[3] *Blair* involved the tax treatment of a trust beneficiary's assignment to his children of an interest in the net income of the trust. The trust had been created by the beneficiary's father, and entitled the beneficiary during his lifetime to the net income of the property held in trust. *Blair*, 300 U.S. at 13. The beneficiary was "the owner of an equitable interest in the corpus of the property," and was entitled to assign all or part of that interest. *Id.* Upon assignment, the assignees "became the owners of the specified beneficial interest in the income," and were taxable on that income. *Id.*, 300 U.S. at 14.

But courts have differed in their characterization of the degree of control that a taxpayer has retained over the fee portion of a judgment subject to a contingent fee arrangement. As the Fifth Circuit panel discussed in *Srivastava,*

> [t]he question, therefore, is one of characterization, and, as we have recognized, is not always easy to apply in particular cases. . . .
>
> [C]ontingent fee contracts defy easy categorization, standing as they do somewhere between the two poles – on the one hand, an obvious scheme to evade taxation through diversion of future income streams to another, and on the other hand, full and complete divestment of an income source.

220 F.3d at 360. It acknowledged that "when a client hires an attorney to prosecute a claim on his behalf, control over that claim . . . is neither fully divested to the attorney nor fully retained by the taxpayer-client." *Id.* The panel announced candidly that application of the control test left it in a quandary. *Id.*

The Seventh Circuit, however, summarily rejected a taxpayer's claim that he relinquished control over his legal claim by entering into a contingent fee agreement: "[the taxpayer] no more relinquished control of the claim to his contingent-fee lawyer than he would have to a fixed-fee lawyer. He could fire either one and would owe either one for work done but not paid for." *Kenseth,* 259 F.3d at 884.

That assessment notwithstanding, those courts that have excluded contingency fees from clients' gross income have concluded that the clients did relinquish control over a portion of their potential judgment, often relying on

state law interpretations of attorneys' liens. *See Cotnam,* 263 F.2d at 125; *Estate of Clarks,* 202 F.3d at 856. *But see Srivastava,* 220 F.3d at 364-65 n.33 (declining to recognize meaningful distinction among state laws governing contingency fees). These courts have stressed the intangible or speculative nature of the property transferred, concluding that ownership of a portion of any recovery passed to the attorney long before it constituted any more than wishful thinking: "[h]ere there was no res, no fund, no proceeds, no vested interest, only a hope to receive money from the lawyer's efforts and the client's right, a right yet to be determined by judge and jury." *Estate of Clarks,* 202 F.3d at 857; *see also Srivastava,* 220 F.3d at 363 (before judgment or settlement, claim is of uncertain value, discussing *Cotnam*).

If the issue is defined as whether the taxpayer-client has given up ownership or control over the lawsuit itself by entering into a contingent fee agreement, then the answer is clear: he or she has not.[4] With all due respect for the *Kenseth* panel however, the debate should not concern whether or to what extent the taxpayer-client has given up control over the legal claim. The issue should rather be whether the taxpayer-client ever had or could have had control over the portion of the anticipated judgment that was designated to his or her attorneys. If, at the time the transfer under the contingent fee agreement was made,

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[4] Under Vermont law, for example, trial counsel has "control over procedural matters incident to litigation; the client has control over the subject matter of litigation." *New England Educ. Training Service, Inc. v. Silver St. P'ship,* 148 Vt. 99, 102, 528 A.2d 1117, 1119 (1987). This is true, of course, regardless of the nature of the fee arrangement.

the taxpayer's rights had not yet ripened to the point that he or she was entitled to the gain, then the taxpayer should not be taxed on that transferred portion. *See Greene v. United States,* 13 F.3d 577, 581 (2d Cir. 1994) (anticipatory assignment of income doctrine applies where fixed right to income has matured at time transfer is made); *see also Wood Harmon Corp. v. United States,* 311 F.2d 918, 926 n.5 (2d Cir. 1963) (anticipatory assignment of income doctrine applies when "assignor is entitled at the time of the assignment to receive the income at a future date, and is vested with such a right," quoting *Cold Metal Process Co. v. Comm'r,* 247 F.2d 864, 873 (6th Cir. 1957)).

State law determines the nature of a legal interest in property, although federal law determines whether that interest was intended to be taxed. *See Morgan v. Comm'r,* 309 U.S. 78, 80 (1940); *see also Aquilino v. United States,* 363 U.S. 509, 512-13 (1960) (in application of federal revenue act, state law controls in determining nature of taxpayer's legal interest). Vermont law provides that "[w]here the parties have contracted that the attorney shall receive a specified amount of the recovered fund, such agreement will create an equitable lien on the fund in favor of the attorney to the extent of the amount stipulated." *Estate of Button v. Anderson,* 112 Vt. 531, 534-35, 28 A.2d 404, 406 (1942); *see also Barnes v. Alexander* 232 U.S. 117, 120 (1914) (contract for contingent fee constitutes lien upon fund awarded, citing *Wylie v. Coxe,* 56 U.S. 415, 420 (15 How. 1853)).

Such a lien is not an automatic feature of every contract for a contingent fee; "[t]he test is whether the party contracting for the services sufficiently indicates an intention to make the fund described in the contract security for the debt." *Button,* 112 Vt. at 536, 28 A.2d at

407. This intent may be implied from the circumstances, and if it appears that the parties looked to the recovery rather than to the owner of the claim for payment of attorneys' fees, then the contingent fee agreement has created an equitable lien. *Id.; see also Valley Disposal Inc. v. Cent. Vt. Solid Waste Mgmt. Dist.,* 113 F.3d 357, 363 (2d Cir. 1997) (discussing *Button*).

The parties in the instant case do not dispute that Raymond and Ouimette & Runcie intended that attorneys' fees for the case, excluding fees on appeal, would be taken from any recovery obtained, and would not become Raymond's personal obligation. Accordingly, under Vermont law, an equitable lien on the IBM recovery was created in favor of Ouimette & Runcie. *Button,* 112 Vt. at 536; 28 A.2d at 407.

A contract that creates a lien for attorneys' fees upon the recovery associated with a claim

> before the allowance of the claim, and before any services ha[ve] been rendered by the attorney, . . . in effect, . . . g[ives] him an interest or share in the claim itself[;] . . . it transfer[s] or assign[s] to the attorney, in advance of the allowance of the claim, such an interest as would secure the payment of the fee stipulated to be paid.

Nutt v. Knut, 200 U.S. 13, 20 (1906); *see also Cotnam,* 263 F.2d at 125 (attorney holding equitable assignment or lien has an interest in cause of action and recovery under it); *Pittman v. United States,* 116 F. Supp. 576, 579 (Ct. Cl.

1953) (contingent fee contract between attorney and client gave attorney an interest in client's claim).[5]

Given that, according to the United States Supreme Court's ruling in *Nutt,* a contingent fee contract effectively confers an interest in the claim itself upon the attorney, the contingent fee agreement operates more like an assignment of income-producing property than an assignment of future income from property. *See Foster,* 249 F.3d at 1280; *Estate of Clarks,* 202 F.3d at 857-58; *cf. Harrison v. Schaffner,* 312 U.S. 579, 583-84 (1941) (noting that the line between the two may be difficult to distinguish in some cases); *Heim v. Fitzpatrick,* 262 F.2d 887, 889 (2d Cir. 1959) (question whether transfer is one of income or of income-producing property is not free from doubt). Several features of the contingent fee agreement reinforce this conclusion. First, the client who obtains legal services on a contingent fee basis incurs no personal obligation for the services provided. *See Button,* 112 Vt. at 536, 28 A.2d at 407; *see also Barnes,* 232 U.S. at 121; *Kenseth v. Comm'r,* 114 T.C. 399, 439 (2000) (Beghe, J., dissenting). The attorney has no recourse if there is no recovery; if there is a recovery the attorney has a lien on – an equitable interest in – the funds recovered. Because the client has not incurred a personal obligation, it scarcely seems logical to conclude, as have panels in the Ninth, Tenth and

[5] Contingent fee contracts in civil cases represent a specific exception to the ethical prohibition against acquiring "a proprietary interest" in a client's cause of action. *See, e.g.,* Vt. Rules of Prof'l Conduct R. 1.8(j)(2) (1999) (lawyer shall not acquire proprietary interest in cause of action or subject matter of litigation, except that lawyer may contract with client for reasonable contingent fee in civil case).

Federal Circuits, that payments under contingent arrangements serve to discharge clients' personal obligations to their attorneys, and therefore, under the rule of *Old Colony Trust,* should be taxed to the clients. *See Old Colony Trust Co. v. Comm'r,* 279 U.S. 716, 729 (1929) (discharge by third person of taxpayer's obligation is equivalent to receipt by taxpayer); *Campbell,* 274 F.3d at 1313-14 (recovery permitted taxpayer to discharge personal obligation owed to attorneys); *Coady,* 213 F.3d at 1191 (taxpayer could not avoid tax by diverting portion of recovery to her creditor contingent fee counsel); *Baylin,* 43 F.3d at 1454 (funds served to discharge obligation of partnership to its attorney).

Second, at the time the taxpayer transfers an interest, it has not matured or ripened into a right to enjoy a gain. It is not that the amount of potential recovery is speculative; it is that the nature if not the existence of the taxpayer's right to receive any recovery has yet to be determined at the time he has given up a portion of that right to his attorney. *See Estate of Clarks,* 202 F.3d at 857 (Clarks had no predetermined property interest before entering contingency fee arrangement)[6]; *see also Greene,*

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[6] *Lucas v. Earl* 's orchard metaphor was refined in *Estate of Clarks* in an attempt to represent the contingent fee relationship more accurately:

> [h]ere the client as assignor has transferred some of the trees in his orchard, not merely the fruit from the trees. The lawyer has become a tenant in common of the orchard owner and must cultivate and care for and harvest the fruit of the entire tract. . . . The situation is no different from the transfer of a one-third interest in real estate that is thereafter leased to a tenant.

202 F.3d at 858.

(Continued on following page)

13 F.3d at 581 (2d Cir. 1994) (if a fixed right to income has not matured at time of transfer, proceeds are not income to transferor, construing anticipatory assignment of income doctrine in charitable donation case); Aaron C. Charrier, *Taxing Contingency Fees: Examining the Alternative Minimum Tax and Common Law Tax Principles,* 50 Drake L. Rev. 315, 340 (2002) (at time of entering into contingent contract, taxpayer has not realized any income; his benefit derives from contingent agreement itself).

Third, contingent fee contracts are not employed as a "skillfully devised," *Earl,* 281 U.S. at 115, tax avoidance scheme, but to provide greater access to legal services, often in doubtful or risky cases, where the clients cannot afford to pay attorneys to pursue their claims. *See* Charrier, 50 Drake L. Rev. at 321-22. Applying the assignment of income doctrine to attorneys' contingency fees is inconsistent with the purpose of the doctrine, which was adopted to thwart tax avoidance schemes. *See Earl,* 281 U.S. at 281; *Basye,* 410 U.S. at 449-50.

Perhaps the most apt agricultural metaphor was created by the dissent in the Tax Court's opinion in *Kenseth,* however, who analogized the contingent fee agreement to cropsharing:

> [t]he attorney is in the position of the tenant farmer, who bears all his direct and overhead expenses incurred in earning the contingent fee. . . . The client is in the position of the landowner . . . , who bears none of the operating expenses, but is responsible for paying the carrying charges on his land. . . . [C]ropsharing arrangements result in a division of the crops and the total gross revenue from their sale in the agreed upon percentages. This income is characterized as rental income to the owner or lessee of the land and farm income to the tenant-farmer.

Kenseth, 114 T.C. at 455 (citation omitted).

Because the contingency fee agreement is not a tax avoidance scheme, operates more like income-producing property than income from property, and in any event does not satisfy the substantial control test of the assignment of income doctrine, this Court holds that the portion of Raymond's recovery that was paid directly to his attorneys under their contingent fee agreement was not income to Raymond. Because the IRS incorrectly required this amount to be included in the Raymonds' 1998 income, the Raymonds are entitled to a refund on their 1998 taxes. The Raymonds' motion for summary judgment is, accordingly, granted; the IRS's motion for summary judgment is denied.

Dated at Burlington, Vermont this 17th day of December, 2002.

/s/ William K. Sessions III
William K. Sessions III
Chief Judge

Supreme Court, U.S
FILED
JUN 14 2004
OFFICE OF THE CLERK

(2)

No. 03-1415

In the Supreme Court of the United States

DAVID A. RAYMOND AND LORI RAYMOND, PETITIONERS

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE UNITED STATES

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QUESTION PRESENTED

Whether, under Section 61(a) of the Internal Revenue Code, 26 U.S.C. 61(a), petitioners' gross income from the proceeds of litigation includes the portion of their damages recovery that was paid to their attorneys pursuant to a contingent fee agreement.

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ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE UNITED STATES

OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1-21) is reported at 355 F.3d 107. The opinion of the District Court (Pet. App. 22-36) is reported at 247 F. Supp. 2d 548.

JURISDICTION

The judgment of the court of appeals was entered on January 13, 2004. The petition for a writ of certiorari was filed on April 9, 2004. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

1. Petitioner David A. Raymond brought suit against IBM Corporation, his employer, for wrongful termination of his employment. He was awarded damages in the amount of $869,156. Pet. App. 23. Under the contingent fee agreement that petitioner had made with his attorneys, the attorneys were authorized to, and did, retain $306,898.01 of the damages award. *Id.* at 24.

Petitioner filed a joint tax return for 1998 with his wife, petitioner Lori Raymond, on which the entire amount of the judgment, including the portion retained by Mr. Raymond's attorneys, was included in gross income. Pet. App. 24. Although petitioners' attorneys fees were deductible for regular income tax purposes, they were not allowable as a deduction for purposes of the alternative minimum tax (AMT). See 26 U.S.C. 56(b)(1)(A)(i). As a consequence, petitioners incurred an alternative minimum tax liability. In December 1999, petitioners filed an amended 1998 return. On the amended return, petitioners excluded from their gross income the amount paid to their attorneys under the contingent fee agreement. This exclusion eliminated petitioners' AMT liability and, on that basis, petitioners claimed that the IRS owed them a refund of approximately $55,000. The IRS denied the claim. Pet. App. 3.

2. Petitioners filed suit in the United States District Court for the District of Vermont, challenging the denial of their refund claim. Petitioners moved for summary judgment, contending that, as a matter of law, the amount paid as a contingent fee to their attorneys was not includable in their gross income. The government cross-moved for summary judgment, arguing that the entire amount of the judgment was includable as gross

income. The district court granted petitioners' motion for summary judgment, holding that petitioners' gross income did not include the portion of their damages award that was paid to their attorneys under the contingent fee agreement. Pet. App. 36.

3. The court of appeals reversed and remanded. Pet. App. 1-21. The court held that petitioners' attorneys did not acquire an ownership interest in the cause of action under the contingent fee agreement, but acquired only a lien—a security interest—in a fund owned by petitioners. *Id.* at 14-15. The court of appeals further held that federal tax law principles explained in *Helvering* v. *Horst*, 311 U.S. 112 (1940), and other decisions of this Court required that the entire amount of the damages award, including the portion paid to petitioners' attorneys, be included in petitioners' gross income. Pet. App. 16-21.

The court explained that "whether something is 'gross income' begins with whether it can reasonably be considered a 'gain' to the taxpayer under 26 U.S.C. § 61(a)." Pet. App. 16. The court rejected petitioners' contention that they received no gain from the attorney's fees portion of the award because they never received those funds and had no right to them in light of the lien placed on them under Vermont law. The court held that this Court's decision in *Horst* makes clear that "a taxpayer can realize a gain subject to taxation where, although he 'never receives the money, he derives money's worth from the disposition of [the source of the income] which he has used as money or money's worth in the procuring of a satisfaction which is procurable only by the expenditure of money or money's worth.'" *Ibid.* (quoting *Horst*, 311 U.S. at 117). The court concluded that Mr. Raymond "control[led] the source of the income [and] . . . divert[ed] the

payment from himself to others as the means of procuring the satisfaction of his wants." *Ibid.* (quoting *Horst*, 311 U.S. at 116-117). Specifically, "[h]e diverted a portion of his judgment to his attorney in the service of receiving the remainder of that judgment—certainly a result 'procurable only by the expenditure of money or money's worth.'" *Ibid.* (quoting *Horst*, 311 U.S. at 117). Accordingly, the court held, "the judgment flowing to [petitioner] is income to him, and the expense of producing that income—his attorney's fee—is a deductible expense." *Ibid.* While the fact that the AMT precludes petitioners from taking advantage of that deduction may be "unfortunate," the court said, "it is not a reason to create an artificial contingent-fee exception to the rule that one is taxable on income from a source over which one retains control." *Id.* at 16-17.

DISCUSSION

This case presents the same question presented in *Commissioner* v. *Banks*, No. 03-892, and *Commissioner* v. *Banaitis*, No. 03-907. The Commissioner's petitions for certiorari in those cases were granted on March 29, 2004, and the cases were consolidated. See 123 S. Ct. 1712 and 1713 (2004). The Court's decision in *Banks* and *Banaitis* in all likelihood will be dispositive here. Accordingly, the petition in this case should be held for appropriate disposition in light of the Court's disposition of *Banks* and *Banaitis*.

CONCLUSION

The petition should be held and then disposed of as appropriate in light of the disposition of *Commissioner* v. *Banks*, No. 03-892, and *Commissioner* v. *Banaitis*, No. 03-907.

Respectfully submitted.

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JUNE 2004